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Classified By: CLASSIFIED BY MINISTER COUNSELOR FOR ECONOMIC AFFAIRS ROBERT LUKE; REASON 1.4 (B) AND (D)

SUMMARY

[1](#)1. (C) Our economic travels to provincial destinations outside Beijing in recent years suggest that the struggle between Central Government and local government officials over the nature of China's economic development is of such complexity and depth that it will be far from resolved by personnel changes associated with the March 2008 National People's Congress (NPC). President Hu has encouraged balanced, sustainable, less resource-intensive development that addresses social and environmental needs as well as growth ("Scientific Development"), and his views were even codified in the Party Constitution during last October's 17th Party Congress. But our travels have consistently shown local governments seemingly unmoved by Hu's push and instead promoting "economic growth at all costs," reflecting in part a desire by some officials to improve their own career prospects -- a cycle that may well start again once new personnel are put in place. China's second- and third-tier cities are rushing to build their own unique urban identities, launching projects of questionable economic value in order to compete with other cities for attention. Local officials guard their own vested interests, and many regions still rely primarily on state-owned enterprises to fuel growth, often to the disadvantage of prospective foreign investors. Efforts to improve China's social safety net have been largely inadequate to support social services in poor areas, and funding also is sometimes diverted to local officials through corruption. The current situation underscores the importance of more intense USG focus on China's interior provinces. END SUMMARY.

¶2. (SBU) This report draws broad conclusions from 22 trips outside Beijing made since September 2005 by post's economic officer who analyzes China's rural and regional economic development. A list of these trips is provided in para 19. While each trip offered specifics about local economic conditions (refetls), we believe that the experiences of these travels taken together point to broader themes about central-provincial economic relations that will be helpful to policy makers and analysts seeking to put in context the impact of upcoming leadership changes on the occasion of the March 2008 NPC.

THE MYTH OF THE CENTRALIZED ECONOMY

¶3. (C) Travel to cities such as Anyang in Henan Province, Jiujiang in Jiangxi Province, or Korla in Xinjiang Autonomous Region, and you will see first-hand how little influence the Central Government exercises over economic development. Local leaders continue to promote "growth at all costs," despite edicts from the National Development and Reform Commission (NDRC) in Beijing to slow growth and develop according to Hu Jintao's Scientific Development Concept (Ref A). The 11th Five-Year Plan calls for 7.5 percent GDP growth and improved energy intensity by 20 percent per unit of GDP, but GDP growth hit 10.7 percent in the first year of the 11th FYP and hit 11.4 percent in 2007. Targets for energy intensity also have not been met in the first two years of the FYP. With 54 percent of China's energy utilized by heavy industry, our contacts say there is little hope that conservation efforts can improve efficiency so long as these

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industries continue to expand.

¶4. (C) Talk to local and provincial officials about the problem, and they say Beijing's edicts are "guidelines" which do not apply to them. Officials in Western China say fast growth is critically important because the region is poor (Ref B). In Central China, the region needs rapid development in order to catch up with the coast (Ref C). (Henan Province's GDP growth rate, for example, has exceeded 14 percent each of the past four years.) Coastal regions boast of being the "engine" of China's development and therefore cannot afford to slow down (Ref D).

¶5. (C) Further exacerbating the problem is that local officials still are evaluated for promotion based on factors such as GDP growth, employment rates, and stability (Ref E). Efforts to introduce new standards, such as social and environmental metrics, have yet to bear fruit, prompting the Central Government to place more emphasis on social and environmental factors during the 17th Party Congress as evidenced by the promulgation of Scientific Development. Our contacts state, however, that as long as promotions depend on rapid economic growth, local officials in the provinces will continue to encourage fixed asset investment (FAI) (which grows at an amazing 30 to 40 percent per year in many localities), including new real estate projects and industrial and technological development zones. As a result, the national economy is surging, local protectionism is prevalent, and macroeconomic policies launched in Beijing to cool the economy often fall on deaf ears in the provinces.

¶6. (C) This is not to say, however, that new efforts are not already underway to cool the economy via Central Government regulation. In 2007, Beijing eliminated the Value Added Tax (VAT) rebate and introduced new export tariffs to slow export-led growth. The Central Government addressed rapid investment growth by administratively applying the brakes on credit growth, requiring banks to halt the issuance of new loans for real estate and other developments. In addition, speculation at the beginning of 2008 suggests that the global

situation -- including a slowing economy in the United States -- could help bring China's GDP growth rate back to single digits in the near future.

"NO DUMB KIDS" -- WHY EVERYONE'S ABOVE AVERAGE

¶17. (C) Significantly slowing growth, however, will require in some measure the cooperation of China's provincial governments, and a look at provincial economic statistics demonstrates the decentralized nature of China's economy. Economic growth in every one of the fourteen provinces, municipalities, and autonomous regions in Beijing's Consular District exceeded the national average during 2006 and 2007. A statistician in Xinjiang Autonomous Region commented on the discrepancy to Econoffs during a visit to Urumchi in 2006. Provincial numbers are higher because of double-counting (for example, Xinjiang and neighboring Gansu claiming the same development project in their GDP figures); as a result of local officials providing higher estimates than the actual situation; or because provinces are reporting the gains from unauthorized infrastructure projects, he said.

¶18. (C) Our contacts tell us the Central Government's response has been to allow the provinces some latitude to double-count, fix the numbers, or launch projects not authorized by the NDRC so long as the gains are marginal and the Central Government can deny knowledge of what is happening. This opportunity emboldens local officials to seize land and turn it into new developments -- a process which remains a significant source of political instability and leads to thousands of localized protests each year. In the most egregious cases, Beijing cracks down on local officials, but the punishments that are meted out usually amount to a slap on the wrist. Establishing more secure land use rights has become a Central Government priority, and the State Council's 2008 Number One Policy Document reemphasized the importance of protecting land use rights (septel to follow).

¶19. (C) The Central Government has even publicly criticized provincial officials. One prime example in 2006 was in Inner Mongolia, where GDP growth hit an astounding 18 percent during the year, and officials were punished when construction of an unauthorized power plant project resulted in the deaths of six workers (Ref F). Central Government officials also criticized the Party Secretary of Henan Province and the Mayor of Zhengzhou for the Zhengdong New District project, stating that the development is an obvious

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example of overheating in the real estate sector (Ref G). We have not seen indications, however, that such punishments have either slowed economic growth in these provinces or slowed these officials' advancement through the Party ranks. In the case of Inner Mongolia and Henan, for example, both grew at an even faster rate in 2007 with Inner Mongolia's GDP growth rate reaching 19 percent and Henan's GDP growing by 14.4 percent during the year.

URBAN IDENTITIES: RACING TO CREATE A "NEW YOU"

¶10. (C) In today's China, second- and third-tier cities are rushing to build their own unique urban identities, launching projects of questionable economic value (i.e., an opera house in Jiujiang or a massive government building in Anyang) in order to compete with other cities for attention. Urban planning exhibitions are common in cities of all sizes, and suburban sprawl is taking root with trendy new communities sprouting up on the outskirts of medium- and large-sized cities.

¶11. (C) In Tianjin, economic planners are launching financial pilot projects, increasing the size of the port, and attracting investors from Motorola to Airbus in order to grow

into an economic juggernaut side-by-side with Beijing, linked to the capital by a high-speed rail (Ref H). Qingdao is doubling the number of five-star hotels in the city in preparation for hosting the sailing events at the 2008 Olympic Games (Ref I). Jiujiang officials want to attract Hong Kong and Taiwanese investment and are building the opera house and a large monument to become a more cultured city (Ref J). Even third-tier cities such as Chi Bi in Hubei Province are building golf courses and other amenities to attract businessmen (see also Refs K, L on Hubei Province). The Vice Mayor of Chi Bi City in Hubei Province told Econoffs in 2006 that the Mayor authorized constructing a golf course despite a moratorium on golf courses imposed by NDRC (which was worried about the loss of arable land from new golf courses) and declared the project on the financial books as a "recreation center" in order to avoid NDRC scrutiny.

PROTECTIONISM WITH REGIONAL CHARACTERISTICS

¶12. (C) As second- and third-tier cities grow and develop their own identities, officials and businessmen zealously guard their own local interests. Economic growth in the provinces is still largely dependent on state-owned enterprises (SOEs), especially in Central and Western China (Refs M, N). Although local officials state that they are interested in attracting foreign investors, they often are not willing to make the regulatory changes that would be necessary to open the local economy and make the area attractive for outside investors. Provincial and local governments launch development zone projects, often offering preferential treatment to local companies. Local rules for foreign investors vary from region to region and city to city, making it difficult for large companies to understand local realities. (See Ref O for a discussion of the impact of local protectionism on the steel sector in Shandong Province.)

¶13. (C) It is especially difficult to break through local barriers in the real estate sector. A Zhengzhou-based real estate entrepreneur told Econoff in 2006 that local connections are extremely important in the city, and it would not matter if a businessman was from Shanghai or New York, they would get nowhere without a local partner. In Qingdao, much of the real estate business is controlled by Municipal SOEs such as Haier and Hisense, which primarily are manufacturers but have diversified into real estate (Ref D). These brand names often drive out smaller real estate companies, which then can operate only in niche areas.

¶14. (C) The local bureaucracies that manage development zones or assist foreign invested enterprises also can be protectionist in nature. An official at the Xian High Tech Development Zone told Econoff in 2007 that his zone always would offer preferential treatment to a local company over a foreigner (Ref P). An American businessman in Qingdao said that his company faces difficulties sorting out which bureaucracy to deal with when there is a problem.

BEIJING'S POLICY FIXES: THE PROVINCIAL VIEW

¶15. (C) Provinces in Central and Western China have welcomed the Central Government's efforts in recent years to promote

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"balanced development" by offering more budget support to poor areas (Ref Q). The New Socialist Countryside, Great Western Development Program, and Central China Rising all are policies aimed at balanced development. From the provincial view, however, the funding provided to these programs is always insufficient. Provincial officials acknowledge that providing free nine-year compulsory education in rural areas and supporting infrastructure (especially roads and airports) in Western China has had a positive impact on development. However, they complain that funding for social programs such

as pensions or health care still is lacking and the government's financial support provided to date has not necessarily helped attract investment from private firms. A prominent social scientist in Beijing repeatedly has said that funding for the New Socialist Countryside, for example, has been woefully inadequate since the policy's launch in late 2005 primarily because the funding is divided between too many Central Government ministries and local levels of government.

¶16. (C) Local officials have, however, been more than willing to enrich themselves with funds provided by the Central Government, and our contacts suggest this corruption (as well as large municipalities' reluctance to foot the bill for social welfare in poor areas) is behind much Central Government hesitation about increases in social spending. A prime example is the New Socialist Countryside policy where some funds have been diverted to build "New Villages." In Gansu Province's Dingxi Prefecture, for example, local officials used funding intended for a village of 300 people to build 30 new townhouse-style villas for village leaders and their friends to live in (Ref B). In 2006, Econoff visited both the Dingxi New Village and a similar project outside Kaifeng in Henan Province (Ref R) -- both of which were clear signs of corruption and misuse of Central Government funding.

COMMENT: POLICIES MUST BE SEEN FROM PROVINCIAL VIEW

¶17. (C) Travel in the provinces long enough and one begins to wonder how China's reliance on SOEs for growth, the government's immature financial and pension systems, the growing income gap between urban and rural areas, and other social problems will affect the country's long-term economic growth trajectory. With provincial and local governments often at odds with the Central Government, it is important to analyze how policies are implemented at the local level. We find repeatedly that policy implementation varies from province to province and locality to locality, making it difficult to make generalizations about China's economic situation from region to region (see also Refs B, C, and D). With continuing friction between the Central Government and local governments, it is unclear how the Central Government will cool down rapid economic growth, or how local leaders will manage to provide sufficient social services and pay attention to environmental protection when the current structure perpetuates a focus on economic growth.

¶18. (C) These trends underscore the importance of more intense USG focus on China's interior provinces. Continued travel by Embassy officers to China's provinces, as well as visits by high-level officials (such as those by Deputy Secretary Negroponte to Guizhou, Secretary Paulson to

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Qinghai, and Secretary Leavitt to Sichuan) will help us better understand Central-Provincial friction and its impact on external economic ties and internal social stability. Travel to the provinces also will help us improve our bilateral economic engagement under the Strategic Economic Dialogue (SED) on the significant challenges China faces as it attempts to rebalance its economy and narrow the income gaps between regions as well as between urban and rural areas.

APPENDIX: LIST OF REPORTING TRIPS

¶19. (SBU) This report draws from the following provincial reporting trips from 2005 to 2007:

--Nov 07--Henan Province (Zhengzhou, Anyang, Kaifeng)
--Nov 07--Shandong Province (Jinan, Qingdao)
--Sep 07--Shanxi Province (Taigu)
--Aug 07--Henan Province (Zhengzhou)
--Aug 07--Ningxia Autonomous Region (Yinchuan, Zhongning, Yanchi)

--May 07--Shaanxi Province (Xian, An Shan)
--Apr 07--Henan Province (Zhengzhou, Luoyang)
--Feb 07--Jiangxi Province (Nanchang, Jiujiang)

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--Jan 07--Tianjin Municipality
--Nov 06--Henan Province (Zhengzhou, Kaifeng)
--Nov 06--Hubei Province (Wuhan)
--Sep 06--Hunan Province (Changsha, Shao Shan)
--May 06--Xinjiang Autonomous Region (Urumchi, Shihezi, Korla)
--May 06--Shandong Province (Qingdao)
--Apr 06--Henan Province (Zhengzhou)
--Apr 06--Gansu Province (Lanzhou, Dingxi)
--Jan 06--Henan Province (Zhengzhou)
--Dec 05--Inner Mongolia Autonomous Region (Huhehote)
--Nov 05--Qinghai Province (Xining, Maduo)
--Oct 05--Hunan Province (Changsha)
--Sep 05--Hebei Province (Shijiazhuang)
--Sep 05--Shandong Province (Qingdao)

(Note: From September 2005 to November 2007, Econoff traveled to each of the fourteen provinces, municipalities, and autonomous regions in Beijing's Consular District. In November 2007, CG Wuhan opened and now includes four provinces -- Hubei, Hunan, Jiangxi, and Henan -- that previously were in Beijing's District. End Note.)
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